



One Market, One Money?

European Lessons for North America

by

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The European Community is a closely integrated trade zone. It operates a pegged-exchange-rate regime, and may soon adopt a common currency. This experience raises questions about the emerging North American free trade area. Some have suggested that a common currency, or at least a system of fixed exchange rates, are necessary for North America.

This inference is not valid. The Community already possesses an institutional base that makes a single currency a viable option. North America

does not. Moreover, Canadian advocates of a fixed exchange rate are arguing for an inflationary devaluation to engineer a short-term competitive advantage *vis-à-vis* the United States. This would weaken, not strengthen, economic links in North America.

The most likely and desirable future for the North American monetary system is the continued existence of national currencies, each with stable purchasing power, and therefore linked by stable, though not fixed, exchange rates.

Introduction

The slogan "One Market, One Money"¹ is European. It summarizes the view that, as the European Community (EC) evolves into a single, supranational economic union, the adoption of a single currency should be an integral, indeed natural, element in that evolution. But North America is developing into a supranational free trade area. An agreement between the United States and Canada is already in place, and one that includes Mexico is soon to be negotiated. Similar arrangements might also come into being with other countries in the Western Hemisphere.

If the Americas are emulating Europe in the matter of trade arrangements, should they not also be reconsidering monetary arrangements? Does not the evolution of a single market in goods and services also point to the desirability of some sort of monetary union — if not initially of a single currency, then at least of a system of fixed exchange rates?

Such arguments are now being heard from those whose interests are being hurt by the currently high level of the Canadian dollar, and are eager to make as strong a case as possible for adopting a fixed (and lower) exchange rate against the United States.

Whatever the other merits of their case, the analogy with Europe is a false one. The "one market" of Western Europe and that of North America are very different entities, and the differences between them are particularly relevant to the question of monetary unification. To put it simply — perhaps overly so — the one European market is part of a broader, albeit as yet quite loose, political union, while the one North American market shows no sign of developing in such a direction.

Monetary union is at least as much a political as an economic matter. It *may*, therefore, be an appropriate aim for the EC, but it is *not* an appropriate aim for North America. This *Commentary* briefly discusses, in the abstract, the pros and cons of the maintenance of separate national currencies, weighs these with reference to the similarities and differences

between the European and North American cases and concludes that the monetary status quo is the best option for North America.

Money, the Market, and the Nation-State

The nation-state is a political entity, not an economic one. If there was any general and always compelling argument that it is economically desirable for a nation-state to maintain its own currency and to reserve the right to have its exchange rate fluctuate against other currencies, then that argument should be applicable to other political entities, too. Why should states or provinces not each have their own currencies? If provinces, why not cities and counties, or wards within cities? This *reductio ad absurdum* could be carried to its limit by asking why each firm or household should not issue its own money — which would draw attention forcefully to the fact that the social purpose of money in the first place is to facilitate market activity among such agents.

It would be ridiculous for city wards to have their own monies because city wards are extremely open economies whose inhabitants trade extensively across their borders. The costs of gathering and processing information about "foreign" currencies and engaging in "foreign"-exchange transactions — not to mention the exchange-rate risks that agents would face in the presence of a multiplicity of city ward monies — would be prohibitive.

Trade does not stop at national boundaries, and agents engaged in international trade face similar information and transactions costs and exchange-rate risks. Why not, then, have the boundaries of a single currency coincide with those of the area over which a substantial amount of trade takes place — in other words, with the economic boundaries of the market, rather than at the political borders of the nation-state? Or, failing that, why not at least minimize the costs generated by the existence of national currencies by maintaining fixed exchange rates within the market area?

What, in short, does a nation-state get out of having its own currency, and what does it get out of permitting the exchange rate of that currency to fluctuate? Among economists, the standard answers to these questions are well known.

The Advantages of a National Money

Symbolism and Seigniorage

To begin with, the typical nation-state still attaches some symbolic importance to the maintenance of a distinct national currency, which is a traditional trapping of national sovereignty. Economics does not help one to understand this matter, but that is no reason to ignore it. It is likely, for example, that much of the popular suspicion in Britain of a common European currency stems from this source. Curiously, however, in debates currently going on in Canada, the advocates of Quebec sovereignty seem to find no attraction in a separate currency.² Be that as it may, this symbolic advantage of a separate national money is to be had under a rigidly fixed exchange rate.

So, too, is the ability that a separate national money confers on the government to raise revenue. Noninterest-bearing currency and the deposits that commercial banks hold with the central bank are the liabilities of that central bank. They are matched by assets largely consisting of interest-bearing government debt. Central banks, however, such as the Bank of Canada, are government owned, and their profits are remitted to the government. Noninterest-bearing central bank liabilities — known as the monetary base — are, in effect, noninterest-bearing government debt. The interest saving that accrues from them, and manifests itself in the form of central bank profits, is properly regarded as a source of government revenue, and — for historical reasons that need not concern us here — is called “seigniorage”.

Seigniorage income is not necessarily a trivial matter, even in conditions of reasonable price stability. If the noninterest-bearing monetary base amounts to two week's income, and the nominal interest rate is equal to, say, 6 percent per annum, then this source will raise revenue at a rate equal to a little less than 0.025 percent of national income. Only to the extent that foreign-exchange reserves are held in noninterest-bearing form — as they would be, for example, under a commodity standard, of which the gold standard is the most familiar case — does a fixed exchange rate shut off this source of revenue. If, for example, Canada were to run a fixed exchange rate on the U.S. dollar, reserves would mainly take the form of interest-bearing short-term U.S. securities, rather than noninterest-bearing gold or U.S. currency. Thus, the Bank of Canada would still generate seigniorage for the Canadian government.

The Control of Inflation

The government of a nation-state can, within limits, increase seigniorage by generating inflation, because inflation drives up the interest rate and, therefore, the interest savings that accrue from having the public hold government debt in noninterest-bearing form. A fixed exchange rate, of course, limits the government's ability to vary seigniorage income by varying the domestic inflation rate. Quite apart from this aspect of the matter, however, the ability to control inflation is of political significance. Here, indeed, lies the very core of the case for maintaining separate national currencies linked by flexible exchange rates.

Inflation is not an economically efficient way of raising revenue, nor does any long-run inflation/unemployment tradeoff exist that could be exploited for policy purposes. Inflation, nevertheless, is a legitimate and important matter of political concern and debate, and those who control it — namely, the monetary authorities — should be accountable to the general public for their performance.³ As long as the political institutions that ensure such accountability exist only at the level of the

nation-state, this consideration argues strongly in favor of maintaining both a national currency and an exchange-rate regime that gives the monetary authorities the necessary room to maneuver.

Adjustment to Shocks

The final element in the traditional case for a separate national currency also requires a flexible exchange rate. Such an arrangement helps an economy facing so-called real shocks — either changes in the terms of trade or variations in capital flows — to adjust wages and prices relative to those abroad. To the extent that nominal wages and prices are slow to adjust — “sticky”, in economists’ jargon, and downward “stickiness” is usually regarded as being particularly relevant here — then exchange-rate movements brought about by market forces can help with such relative adjustments and lessen potential job losses.

A number of comments on this argument are in order. To begin with, the very same slowness of wages and prices to adjust in the face of real economic shocks that makes a flexible exchange rate desirable also underlies the mechanisms that lead exchange-rate fluctuations to amplify the consequences of monetary shocks and to overshoot their longer-term equilibrium values when such shocks occur. Thus, to deploy “wage-and-price stickiness” in defense of a flexible exchange rate is to imply that the real shocks to which the economy is vulnerable are more frequent and serious than are the monetary shocks. This might be a valid element in arguing for a particular country to maintain a flexible exchange rate at a specific case, but it cannot be part of any blanket defense of the general superiority of such a regime.

Second, one cannot help but wonder whether the degree of “wage-and-price stickiness” that characterizes an economy is going to be completely independent either of its exchange-rate regime or of the shocks to which it is normally subjected.

Finally, a central bank that is intent on fine tuning the economy can use a flexible exchange rate as a policy instrument. All of the usual arguments against fine tuning apply here, and the opportunity that a flexible exchange rate confers on the monetary authorities to indulge in fine tuning is not an advantage.⁴

Changes in the terms of trade and fluctuations in capital flows take place within, as well as across, national boundaries. So the above argument about smoother adjustment can be advanced — and, in the case of western Canada, sometimes is advanced — to support the proposition that the boundaries of currency areas might be drawn more narrowly than those of nation-states. The usual counter to this point is that the opportunities for labor mobility and the capacity for interregional fiscal transfers that exist within a nation-state provide alternative means of cushioning the impact of real shocks. This argument has obvious relevance to the question of the desirability of any supranational monetary union. If it is part of a broader economic union, with provision for ensuring international labor mobility and the implementation of international fiscal transfers, then such a monetary union is more likely to be viable.

Europe and North America Compared

A Common Market and a Free Trade Area

In the light of these arguments, then, is it desirable for the one European market to have one money, and for the one North American market to emulate it, at least to the extent of moving to fixed exchange rates? Regardless of the specific answers that one gives to these complex questions, it is easier to make the case for a single money for Europe than for North America, and it is extremely dubious that it can be made at all in the latter case.

At the outset, the EC was a *common market*, and it has become an *economic community*. A common market, by definition, maintains a common external tariff. In the European case, it has also maintained a Common Agricultural Policy (CAP), along with some capacity to make fiscal transfers to depressed regions. The administration of these arrangements has required the existence of a market-wide bureaucracy, and has also led to the creation of a European parliament — albeit with very limited powers — to oversee the substantial budget involved. The EC has a common passport, and few legal or administrative restrictions on labor mobility within the Community for its holders.

In North America, there is a *free trade area* consisting of Canada and the United States, from which several important sectors — for example, most of agriculture — are exempted. The extent of the supranational institutions created under the Canada-U.S. Free Trade Agreement (FTA) goes no further than *ad hoc* dispute settlement panels and an agreement to negotiate a common policy on what constitutes a subsidy. National rules, made by national governments, still govern trade across national borders. The FTA left immigration laws untouched — apart from making the transborder provision of professional services a little easier — and surely the desire to *reduce* incentives to transborder labor mobility is not altogether absent as Canada and the United States seek to include Mexico in a broader agreement.

Alternative Adjustment Mechanisms in Europe and North America

There are several implications of all this. First, in Europe — but not in North America — there are alternative ways to adjust to real shocks, involving international fiscal transfers and labor mobility, which can, in principle, take the place of exchange-rate flexibility.

Even within Europe, the existence of such mechanisms was insufficient to persuade Britain, a large oil producer and center of an

important capital market and, hence, a potential recipient of differential real shocks, to give up a flexible exchange rate until very recently. Why should Canada — whose terms of trade *vis-à-vis* the United States can be volatile, and for whom transborder capital movements are extremely important — give up the exchange-rate-adjustment mechanism in the absence of any alternative?

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More generally, and more importantly, European countries have already surrendered a certain amount of political sovereignty to Brussels, where the EC bureaucracy is located, and to Strasbourg, where its parliament meets, and the institutions already exist through which, perhaps, the seigniorage generated by a European central bank might be collected and allocated and through which that bank might be held accountable for its performance.

Moreover, it should be noted explicitly that, during the 1970s, the EC encountered

serious difficulties in maintaining its CAP in the face of large and frequent exchange-rate fluctuations among its members' currencies. Much is made of the discipline that the European Monetary System (EMS) — a pegged-exchange-rate regime — imposed on members in the 1980s. But surely some of the discipline needed to keep the EMS in place and to move the system toward a closer union has come from a deeper desire to protect the CAP, which, if not quite the EC's *raison d'être*, is its single most important institution. No comparable institution exists in North America.

The Fixed-Exchange-Rate Option

Given the absence in North America of common political and bureaucratic institutions, and of the alternative adjustment mechanisms that these make possible, a new currency for the region seems beyond the bounds of possibility. But fixed exchange rates on the U.S. dollar for both Canada and/or Mexico are not.

If, however, exchange rates were rigidly and perpetually fixed, the dominant size of the U.S. market and currency area would require that Canada and Mexico surrender control of inflation — a matter of domestic political concern — to the U.S. Federal Reserve system — a central bank responsible to the U.S. electorate. It is hard to believe that this would be politically acceptable in either country, or that the alternative — namely, permitting foreign representation in the policymaking bodies of the Federal Reserve System — would be acceptable in the United States.

What about a potentially adjustable peg? The trouble here is that one then has to face all of those traditional arguments about an adjustable peg's bringing with it the worst features of a fixed rate — and of a flexible rate, too.⁵ Argument from the example of the EMS seems barely relevant to the case of North America. The same worries about changes in the terms of trade and capital-account fluctuations that kept Britain out of the European pegged-exchange-rate mechanism for so long are present in the North American economy;

furthermore, the jury is still out as to whether Britain was wise to change its policy in 1990.

If the verdict should prove favorable, that will stem, in part, from the coincidence of Britain's entry with the monetary disturbances associated with German reunification: Without some inflation in Germany, Britain's adjustment problems would have been severe. More importantly, however, it may stem from the view that Britain's entering the mechanism was a large step in the direction of catching up with an altogether more broadly based movement toward European economic and political integration. There is no discernible counterpart to this movement in North America.

Be all that as it may, voices are now being heard in Canada urging the adoption of a fixed exchange rate. A good deal of the support for such a policy change has come about because of the rise in the value of the Canadian dollar since the FTA was signed, which has swamped the gains that Canadian producers hoped to obtain from easier access to U.S. markets. These arguments for fixing the exchange rate should be treated with suspicion.

To begin with, no one in Canada is urging that the exchange rate be fixed at its current level — although U.S. beneficiaries of the FTA might find such a measure attractive! Rather, Canadian advocates of a fixed rate are arguing for a deliberate devaluation. Although most observers — including the author — have been surprised by the current high exchange rate, this does not alter the fact that a deliberate policy of trying to reduce it would be inflationary. The Bank of Canada would have to create new Canadian dollars in order to drive the exchange rate down, and such a measure would also drive up domestic wages and prices. Hence, such a policy would not restore Canada's competitive position in the way its advocates hope.⁶

Some advocates of fixing the exchange rate at a lower level would like to accompany devaluation with "effective" wage-and-price controls in order to combat this effect. But such people ignore two issues. First, how does one ensure that controls would indeed be effective? Sec-

ond, if that difficult hurdle is cleared, how does one prevent the success of controls breathing new — and, in the circumstances, unwelcome — life into negotiations about what does and does not constitute a subsidy? It is hard to imagine U.S. legislators failing to react if Canada were to attempt to gain competitive advantages through an active policy of devaluation and wage-and-price controls.

The Prospect for Exchange-Rate Stability in North America

For all that, the more transborder trade in goods, services, and capital that takes place, the greater are the transactions costs and exchange-rate risks to which agents are exposed. In the absence of the political institutions that could make a common currency or rigidly fixed exchange-rate regime viable, more exchange-rate stability would still be better than less.

Stability, however, is not the same thing as fixity, and there are certain market mechanisms tending to produce it anyway. Although national currencies predominate in domestic transactions as a result of custom, reinforced perhaps by legal restrictions, agents engaged in international transactions have a choice of which currency to use. If stability in purchasing power is important to them — and it clearly is — then a more stable currency will be preferred to a less stable alternative.

This very fact gives an incentive to national authorities on both sides of any border to deliver stability in the purchasing power of the money for which they are responsible. If they respond to those incentives, then exchange-rate stability should result — apart from the effects of such real shocks as terms-of-trade changes discussed above. That is to say, the market for the means of exchange is contestable at the national frontier, and the fewer restrictions there are on transborder transactions, the more likely it is that competitive

mechanisms will deliver, if not one money for the whole market, then at least rather stable exchange rates between the currencies circulating in various parts of it. In other words, the existence of free trade makes the pursuit of price stability by central banks more economically desirable than ever, and more likely to be achieved.

Concluding Comments

It is certainly true that there are benefits — in terms of lowering transactions costs — to be had from using one money in one market. But it is also true that certain political factors — involving the management of inflation and, less importantly, the economy's response to real shocks — argue in favor of the maintenance of separate national currencies, even when countries are deeply involved in mutually beneficial and only lightly regulated international trade in goods, services, and capital. There can be no single rule telling us how to balance off these factors in each and every instance.

In the case of the EC, it may well be that the development of supranational bureaucratic and political institutions is already so far advanced that the politics of monetary and stabilization policy can be accommodated within them. If that is so, then "one money for one market" is a defensible slogan for Europe.

For North America, however, the institutional framework to justify such a move seems completely absent. The one market in this instance is an altogether less highly integrated entity — economically, let alone politically — than its European counterpart. For North America, then, the likely outcome, at least for the medium term, is "three markets, becoming more closely linked, with three monies, all converging on stable purchasing power and hence on rather stable exchange rates, too" — accurate perhaps, but hardly the stuff from which a pithy slogan can be fashioned.

Notes

1. An earlier version of this paper was delivered at a panel discussion on "Trade Zones and Currency Zones", held at a conference on "Policy Implications of Trade and Currency Zones", organized by the Federal Reserve Bank of Kansas City at Jackson Hole, Wyoming, August 22-24, 1991. The paper is published in this format by kind permission of the Federal Reserve Bank of Kansas City.)
2. For a detailed discussion of the arguments for and against a separate currency for Quebec in the event of political separation, see David E.W. Laidler and William B.P. Robson, with Lloyd C. Atkinson et al., *Two Nations, One Money? Canada's Monetary System following a Quebec Secession*, The Canada Round 3 (Toronto: C.D. Howe Institute, 1991). Contributors to that publication stress the credibility problems that would accompany the launching of a new Quebec currency, and these have no parallel in the context of this *Commentary*.
3. Let it be clear, though, that by "accountable", I do not mean "under direct control". As I have argued at greater length elsewhere, it seems to be important to insulate those in charge of monetary policy from any interest in maximizing seigniorage, or in attempting to fine tune the unemployment rate, while ensuring that they are simultaneously given strong incentives to aim for a low inflation rate and are answerable for their performance on this score. See David E.W. Laidler, "Price Stability and the Monetary Order" (Paper prepared for the 1991 Bank of Japan and Institute of Economic and Monetary Studies Conference, Tokyo [October 24-25], Mimeographed).
4. For a discussion of the relevance of these arguments to the Canadian case, see David E.W. Laidler and William B.P. Robson, *The Fix Is Out: A Defense of the Floating Canadian Dollar*, C.D. Howe Institute Commentary 18 (Toronto: C.D. Howe Institute, 1990), in which it was concluded that, on balance, they add weight to the case for maintaining a flexible exchange rate on the U.S. dollar.
5. These are discussed in *ibid*.
6. It is important here to distinguish between a policy of driving down the exchange rate, which would be inflationary, and one that permits it to fall, if market forces wish it to do so, while maintaining domestic monetary stability.

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